

## Appendix D – Physical Commodities Legal Authorities

Type of Authority	Covered Entities	Applicable Statutes, Rules and Guidance	Scope of Activities
<b>1. Banking and “Closely Related to Banking” Activities</b>	All BHCs and FHCs.	12 U.S.C. §§ 1843(a), (c)(8)  12 C.F.R. §§ 225.21(a), 225.28(a)-(b), 225.123, 225.126, 225.129, 225.131	<ul style="list-style-type: none"> <li>• Within 2 years of becoming a BHC (subject to 3 one-year extensions from the Board), a BHC may only own shares in banks, or engage in, or own companies that engage in, banking activities or activities that the Board has determined by regulation or order to be “so closely related to banking as to be incident thereto.”<sup>1</sup></li> <li>• The Board has determined that commodities derivatives activities are “closely related to banking” as long as the contract requires cash settlement or the BHC makes every reasonable effort to avoid physical delivery or receives and instantaneously transfers the asset by operation of contract and without taking physical delivery.<sup>2</sup></li> <li>• BHCs generally must file a notice with the Board and receive approval prior to engaging in any “closely related to banking” activities.<sup>3</sup> FHCs and certain well-capitalized and well-managed BHCs may commence the activities and file a notice after the fact.<sup>4</sup></li> </ul>

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<p><b>2. “Financial in Nature” Activities and Merchant Banking</b></p>	<p>All FHCs.</p>	<p>12 U.S.C. §§ 1843(k)(1), (k)(4)(H), (k)(7)</p> <p>12 C.F.R. 225 Subpart J (225.170-177)</p> <p>Fed. Res. Interp. Ltr. from J. Mattingly, Esq. to P. Grauer (Credit Suisse First Boston) (Dec. 21, 2001)</p>	<ul style="list-style-type: none"> <li>• All FHCs are permitted to engage in, and to acquire and own shares of any company engaged in, activities that are “financial in nature or incidental to such financial activity.”<sup>5</sup></li> <li>• Merchant banking is a permissible “financial in nature” activity for FHCs and their non-depository institution subsidiaries.<sup>6</sup></li> <li>• The merchant banking authority permits an FHC to:             <ul style="list-style-type: none"> <li>• acquire an ownership interest in any company as “part of a bona fide underwriting or merchant or investment banking activity,”<sup>7</sup> so long as the FHC controls (i) a registered broker-dealer or (ii) insurance company that is advised by a registered investment adviser;<sup>8</sup></li> <li>• hold such ownership interests “only for a period of time to enable the sale or disposition thereof”, which period generally may not exceed 10 years;<sup>9</sup></li> <li>• select all of the directors of a portfolio company;<sup>10</sup></li> <li>• enter into an agreement with a portfolio company giving it approval rights over non-routine matters;<sup>11</sup> and</li> <li>• provide advice to officers and employees of a portfolio company.<sup>12</sup></li> </ul> </li> <li>• The merchant banking authority does not permit FHCs to:             <ul style="list-style-type: none"> <li>• own assets other than securities or other ownership interests in a portfolio company, unless the assets are held by a portfolio company that maintains a separate existence from the FHC and has separate management; or</li> <li>• “routinely manage or operate a portfolio company”<sup>13</sup> other than for a limited period</li> </ul> </li> </ul>

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<p><b>3. “Complementary” Activities</b></p>	<p>FHCs that have applied to, and received approval from the Board, to engage in specific complementary activity.</p>	<p>12 U.S.C. §§ 1843(j), (k)(1)(B).</p> <p>12 C.F.R. § 225.89</p> <p>Board complementary activities orders, including Citigroup (2003), Barclays (2004) and RBS (2008)<sup>15</sup></p>	<ul style="list-style-type: none"> <li>• FHCs are permitted to engage in, and to acquire and own shares of any company engaged in, any activity that the Board has determined by regulation or order “is complementary to a financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally.”<sup>16</sup></li> <li>• A FHC must request approval from the Board to engage in a complementary activity, which the Board will evaluate as to whether the benefits to the public outweigh potential adverse effects.<sup>17</sup></li> <li>• In a series of orders beginning with the Citigroup order, the Board has determined that the purchase and sale of commodities in the spot market and taking physical delivery of commodities in connection with commodity derivatives activities—including owning and disposing of nonfinancial commodities (collectively, “Physical Trading Activities”)—are complementary to the financial activity of engaging as principal in BHC-permissible (<i>i.e.</i>, cash settled) derivatives activities based on those commodities.</li> <li>• As conditions to approval of its proposed Physical Trading Activities, Citigroup committed:             <ul style="list-style-type: none"> <li>• that the market value of commodities held as a result of the activities would at no time exceed 5 percent of Citigroup’s consolidated Tier 1 capital;</li> <li>• that it would notify its supervising Reserve Bank if the market value of commodities held by Citigroup as a result of its Physical Commodities Trading activities exceeded 4 percent of its Tier 1 capital;</li> <li>• to only make and take delivery of physical commodities for which derivatives had been approved for trading on a U.S. futures exchange by the CFTC, unless the</li> </ul> </li> </ul>

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<p><b>4. “Grandfathered” Activities</b></p>	<p>Any company that is not a BHC or foreign bank that becomes a FHC after November 12, 1999.</p>	<p>12 U.S.C. § 1843(o).</p>	<ul style="list-style-type: none"> <li>• Any company that is not a BHC or foreign bank that becomes a FHC after November 12, 1999 “may continue to engage in, or directly or indirectly own or control shares of a company engaged in, activities related to the trading, sale, or investment in commodities and underlying physical properties that were not permissible for bank holding companies to conduct in the United States as of September 30, 1997” if certain conditions are met.<sup>19</sup></li> <li>• These conditions are:               <ul style="list-style-type: none"> <li>• that the FHC or one of its subsidiaries was engaged in any of such activities as of September 30, 1997;</li> <li>• that the value of the assets of the company held by the FHC that are not otherwise permissible for a FHC are equal to or less than 5% of the total consolidated assets of the FHC (except as permitted by the Board); and</li> <li>• that the FHC does not permit the company whose shares the FHC owns pursuant to section 4(o) to offer or market any product or service of an affiliated depository institution or vice versa.</li> </ul> </li> <li>• The Board has not publicly interpreted the scope of the authority for FHCs to engage in grandfathered activities, <i>i.e.</i>, whether section 4(o) permits FHCs only to engage in physical commodities activities and hold physical properties engaged in/held under section 4(o) as of a particular point in time (e.g., 1997, 1999, date of becoming a BHC, etc.).</li> </ul>

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<p><b>5. Sub-5% Investments</b></p>	<p>All BHCs and FHCs.</p>	<p>12 U.S.C. § 1843(c) (6).</p>	<ul style="list-style-type: none"> <li>• BHCs are permitted to own “shares of any company which do not include more than 5 per centum of the outstanding voting shares of such company.”<sup>20</sup></li> <li>• BHCs may own more than 5% of the economic interest in such a company, but the size of such additional economic ownership may depend on the facts and circumstances.</li> <li>• Sub-5% investments must be passive and non-controlling in nature.</li> </ul>



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## (Footnotes)

- 1 12 U.S.C. §§ 1843(a)(2), (c)(8).
- 2 12 C.F.R. § 225.28(b)(8)(ii). FHCs are also permitted to own commodities that state member banks are permitted to own – such as gold and silver bullion. *Id. at § 225.28(b)(8)(ii)(B)(1), (b)(8)(iii).*
- 3 12 U.S.C. § 1843(j)(1)(A).
- 4 *Id. at § 1843(j)(3)-(4).*
- 5 *Id. at § 1843(k)(1)(A).*
- 6 *Id. at § 1843(k)(4)(H).*
- 7 *Id. at § 1843(k)(4)(H)(ii)(II).*
- 8 12 C.F.R. § 225.170(f).
- 9 *Id. at § 225.172(b).* The 10-year period should begin running from the later of the date when a company becomes an FHC (if it holds the ownership interests in the portfolio company on that date) or when the FHC acquires the interests in the portfolio company. For example, a company that becomes an FHC and receives the maximum three one-year extensions from the Board to conform its activities to the BHCA (for a total of five years after becoming an FHC) would have to dispose of an ownership interest in a portfolio company that it held at the time it became an FHC within five years of the end of the conformance period (if the FHC relies on the merchant banking authority to hold such ownership interest).
- 10 *Id. at § 225.171(d)(1).*
- 11 *Id. at § 225.171(d)(2).*
- 12 *Id. at § 225.171(d)(3).*

- 13     Id. at § 225.171(a). The rule provides examples of what constitutes “routine management or operation” of a portfolio company. “Routine management or operation” generally includes when any FHC director, officer or employee serves as an executive officer or employee of a portfolio company or when any portfolio company officer or employee is supervised by a director, officer or employee of the FHC (other than in its role as director of the portfolio company). See id. at § 225.171(b). See also Fed. Res. Interp. Ltr. from J. Mattingly, Esq. to P. Grauer (Credit Suisse First Boston) (Dec. 21, 2001) (available at [http://www.federalreserve.gov/boarddocs/legalint/bhc\\_changeincontrol/2001/20011221/](http://www.federalreserve.gov/boarddocs/legalint/bhc_changeincontrol/2001/20011221/)) (providing a list of example covenants that would not involve a FHC routinely managing or operating a portfolio company).
- 14     Id. at § 225.171(e).
- 15     Citigroup Order; Barclays Order; RBS Order.
- 16     12 U.S.C. § 1843(k)(1)(B).
- 17     Id. at §§ 1843(j)(1)(A), (j)(2).
- 18     After the Citigroup Order, the Board has since permitted FHCs to make and take delivery of physical commodities for which derivatives have not been approved for trading on a U.S. futures exchange by the CFTC. See RBS Order.
- 19     Id. at § 1843(o).
- 20     12 U.S.C. § 1843(c)(6).